BEFORE THE

ARIZONA CORPORATION COMMISSION

1996 CONSOLIDATED COST DOCKET **IN THE MATTER OF THE PETITION OF AMERICAN COMMUNICATIONS SERVICES, INC. AND AMERICAN COMMUNICATIONS SERVICES OF PIMA COUNTY, INC. FOR ARBITRATION WITH U S WEST COMMUNICAIONS, INC. OF INTERCONNECTION RATES, TERMS, AND CONDITIONS PURSUANT TO 47 U.S.C. § 252(b) OF THE TELECOMMUNICATIONS ACT OF 1996.**	**DOCKET NO. U-3021-96-448, CONSOLIDATED WITH:** **U-3245-96-448** **U-2428-96-417** **U-2752-96-362** **U-3016-96-402** **U-3175-96-479** **U-3009-96-478** **E-1051-96-478**

DIRECT TESTIMONY OF

SUSANNE J. MASON

SEPTEMBER 25, 1996

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I. QUALIFICATIONS

Q. PLEASE STATE YOUR NAME, POSITION, EMPLOYER, AND BUSINESS ADDRESS.

A. My name is Susanne J. Mason. I am employed by U S WEST Communications, Inc. ("U S WEST"[1]) as the Director-Arizona Regulatory. My business address is 3033 N. 3rd St., Phoenix, AZ.

Q. WHAT IS YOUR EDUCATIONAL BACKGROUND?

A. I received a Bachelor of Arts degree in Mathematics from Phillips University in 1978 and a Master of Science degree in Telecommunications from the University of Colorado in 1991.

Q. WOULD YOU BRIEFLY OUTLINE YOUR EMPLOYMENT BACKGROUND.

A. I began my career with Mountain Bell in 1978 in Boise, Idaho. During my early career, I held various management positions in customer service, network

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1 In my testimony, all references to U S WEST Communications Group, Inc., and U S WEST refer exclusively to the U S WEST Communications Group, Inc., and have no connection to the U S WEST Media Group or its subsidiaries.

engineering and finance. In 1981, I transferred to Costs, Rates and Regulatory Matters where I worked on cost and pricing for basic exchange toll and private line services. In 1988 I began an assignment in the Issues Management group of Public Policy. My role in this organization was to analyze trends in the telecommunications industry, identify emerging issues, and make policy recommendations on those issues. From mid 1992 through 1994, I worked in a small organization at U S WEST, Inc. that developed overall wireless strategy. In January 1995, I assumed my current responsibilities.

Q. WHAT ARE YOUR CURRENT RESPONSIBILITIES?

A. I am currently responsible for U S WEST's regulatory activities in Arizona.

II. PURPOSE OF TESTIMONY

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to provide an overview of U S WEST's recommendations in this proceeding and to sponsor the prices the Company proposes to charge for interconnection services.

My testimony is provided in concert with the other witnesses filing on behalf of U S WEST; Mr. Jerrold Thompson, Ms. Geraldine Santos-Rach, and Dr. Robert Harris.

Q. PLEASE DESCRIBE THE TESTIMONY OF U S WEST'S OTHER WITNESSES.

Mr. Thompson addresses the financial impacts of the FCC's interconnection order on the Company's revenues and its ability to generate the capital necessary to make future investments in the network. Ms. Santos-Rach describes U S WEST's TELRIC and Avoided Cost studies, including the basic inputs and assumptions. U S WEST's interconnection prices and resale discounts are based on the results of these cost studies. Dr. Harris discusses the competitive and market implications of various costing and pricing approaches. In addition, he validates the Company's cost study methodology and results.

III. OVERVIEW

Q. WHAT ARE U S WEST'S OVERALL RECOMMENDATIONS IN THIS PROCEEDING?

A. U S WEST has four general recommendations in this proceeding.

First, U S WEST recommends that the Commission adopt the TELRIC studies presented by U S WEST in this docket. As Ms. Santos-Rach and Dr. Harris both testify, these studies fully conform to the principles set forth in the FCC's First Report and Order In the Matter of *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996* CC Docket No. 96-98 (First Interconnection Order). Not only do the studies comply with the FCC's order, but Ms. Santos-Rach and Dr. Harris also provide internal and external data which demonstrates the reasonableness of the costs.

Second, U S WEST recommends that the Commission adopt the Avoided Cost studies presented by U S WEST in this docket. Discounting retail products by some fictitious cost that may or may not be avoided in the future is not sound public policy and will result in price increases for U S WEST's retail customers.

Third, U S WEST recommends that the Commission set prices for U S WEST's interconnection, unbundled, and resold services at a level that will allow the Company a fair opportunity to compete in the marketplace and earn a reasonable return on its investment in Arizona. The prices for interconnection services -- including interconnection, transport, termination -- and unbundled services should be set at the TELRIC costs plus a reasonable allocation of common costs. Resale prices should be set at U S WEST's retail rate minus its true avoided costs. The Commission should adopt the specific prices proposed by U S WEST (Exhibits A through J). In adopting these prices, the Commission should delay implementing geographic deaveraging until it also deaverages U S WEST's retail rates.

Fourth, U S WEST recommends the Commission give careful consideration to the consumer impacts of decisions reached in this proceeding. Setting rates that are too high may create barriers which will delay or even possibly preclude the entry of new competitors into the market. However, setting prices that are too low could have an even greater negative impact on consumers. Prices that are too low would eliminate U S WEST's ability to expand and maintain its existing network. This is not a matter of choice for U S WEST; as Mr. Thompson describes, there will simply be no money available to invest. In addition, interconnection and resale prices that are too low also eliminate the incentives for other companies to invest in competing facilities-based networks. Without facilities-based competition, customers will not realize the true benefits of competition.

In the remainder of my testimony, I will review the pricing principles established in the Telecommunications Act of 1996 (the Act) and methodologies contained in the FCC's August 8, 1996 First Report and Order In the Matter of *Implementation of the Local Competition Provisions in the Telecommunications Act of 1996* CC Docket No. 96-98 (First Interconnection Order). I will discuss how U S WEST's prices conform with those principles and methodologies, and discuss some of the implications of the decision in this proceeding.

IV. PRICING

A. THE FEDERAL ACT

Q. HOW DOES THE FEDERAL ACT ADDRESS PRICING?

A. Section 252 (d) contains pricing standards for three categories: (1) interconnection and network elements, (2) transport and termination of traffic, and (3) wholesale prices for telecommunications services.

Q. WHAT IS THE PRICING STANDARD FOR INTERCONNECTION AND UNBUNDLED NETWORK ELEMENTS OUTLINED IN SECTION 252(D)(1)?

A. The Act prescribes the following pricing standards for interconnection and network elements:

> "(1) INTERCONNECTION AND NETWORK ELEMENT CHARGES.--Determinations by a State commission of the just and reasonable rate for the interconnection of facilities and equipment for purposes of subsection (c)(2) of section 251, and the just and reasonable rate for network elements for purposes of subsection (c)(3) of such section--
>
> "(A) shall be--
>
> "(i) *based on the cost* (determined without reference to a rate-of-return or other rate-based proceeding) of providing the interconnection or network element (whichever is applicable), and
>
> "(ii) *nondiscriminatory*, and

"(B) *may include a reasonable profit.*[2]

Q. WHAT IS THE PRICING STANDARD FOR TRANSPORT AND TERMINATION OUTLINED IN SECTION 252(D)(2)?

A. The Act prescribes the following pricing standards for transport and termination:

"(2) Charges for transport and termination of traffic.--

"(A) IN GENERAL.--For the purposes of compliance by an incumbent local exchange carrier with section 251(b)(5), a State commission shall not consider the terms and conditions for reciprocal compensation to be just and reasonable unless--

"(i) such terms and conditions *provide for the mutual and reciprocal recovery* by each carrier of costs associated with the transport and termination on each carrier's network facilities of calls that originate on the network facilities of the other carrier; and

"(ii) such terms and conditions determine such costs on the basis of a reasonable approximation of the *additional costs* of terminating such calls.[3]

Q. WHAT IS THE PRICING STANDARD FOR RESALE OUTLINED IN SECTION 252(D)(3)?

A. The Act prescribes the following pricing standards for resale:

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2 Telecommunications Act of 1996, Section 252(d)(1).

3 Telecommunications Act of 1996, Section 252(d)(2).

> "(3) WHOLESALE PRICES FOR TELECOMMUNICATIONS SERVICES.--For the purposes of section 251(c)(4), a State commission shall determine wholesale rates on the basis of retail rates charged to subscribers for the telecommunications service requested, excluding the portion thereof attributable to any marketing, billing, collection, and other costs that will be avoided by the local exchange carrier.[4]

Q. DO THE PRICING PROPOSALS PRESENTED BY U S WEST IN THIS PROCEEDING COMPLY WITH THESE PRICING STANDARDS?

A. Yes, they do. In addition, the prices proposed in this proceeding meet the relevant checklist requirements specified in Section 271 of the Act.

B. THE FCC'S FIRST INTERCONNECTION ORDER

Q. HOW DOES THE FCC ADDRESS PRICING ISSUES IN ITS FIRST INTERCONNECTION ORDER?

A. The FCC believes that Congress intended a complementary role between state and Federal regulators in establishing prices for interconnection and unbundling. The FCC believes its role is to establish national pricing rules, and that the role of the state commissions is to establish specific rates that are consistent with the FCC's rules.[5] In keeping with that view, the FCC's First Interconnection Order contains

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4 Telecommunications Act of 1996, Section 252(d)(3).

5 First Interconnection Order, Para. 111.

a lengthy section on the pricing of interconnection and unbundled elements (Paragraphs 618 through 862). In addition, the resale portion of the order also includes a section on wholesale pricing.

Q. WHAT PRICING RULES DID THE FCC ESTABLISH FOR INTERCONNECTION, UNBUNDLING, TERMINATION AND TRANSPORT?

A. The FCC has established *one set* of pricing rules that applies universally to interconnection, unbundled network elements, termination and transport. In the First Interconnection Order, the FCC concluded that:

> The pricing standards established by section 252(d)(1) for interconnection and unbundled elements, and by section 252(d)(2) for transport and termination of traffic, are sufficiently similar to permit the use of the same general methodologies for establishing rates under both statutory provisions. . . We. . .find that the "additional" cost standard permits the use of the forward-looking, economic cost-based pricing standard that we are establishing for interconnection and unbundled elements.[6]

Q. PLEASE SUMMARIZE THE OVERARCHING PRICING PRINCIPLE THAT THE FCC HAS ESTABLISHED.

A. The FCC has prescribed pricing rules that adhere to the following overarching pricing principle:

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6 First Interconnection Order, Para. 1054.

> We conclude here that prices for interconnection and unbundled elements pursuant to sections 251(c)(2), 251(c)(3), and 252(d)(1), should be set at forward-looking long run economic cost. In practice, this will mean that *prices are based on the TSLRIC of the network element, which we will call Total Element Long Run Incremental Cost (TELRIC) and will include a reasonable allocation of forward-looking joint and common costs.*[7] (emphasis added)

Thus, per the FCC's rules, the prices for interconnection, unbundled network elements, termination and transport must all be based on TELRIC studies that include an allocation of shared and common costs.

Q. WHAT PRICING RULES OR GUIDELINES DID THE FCC ESTABLISH FOR RESALE?

A. In the First Interconnection Order, the FCC stated:

> The avoided costs are those that an incumbent LEC would no longer incur if it were to cease retail operations and instead provide all of its services through resellers. Thus, we reject the arguments of incumbent LECs and others who maintain that the LEC must actually experience a reduction in its operating expenses for a cost to be considered "avoided" for purposes of section 252(d)(3). We do not believe that Congress intended to allow incumbent LECs to sustain artificially high wholesale prices by declining to reduce their expenditures to the degree that certain costs are readily avoidable. We therefore interpret the 1996 Act as requiring states to make an objective assessment of what costs are reasonably avoidable when a LEC sells its services wholesale.[8]

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7 First Interconnection Order, Para. 672.

8 First Interconnection Order, Para. 911.

In requiring the states to "objectively" determine which costs are "reasonably avoidable," under the specific assumption that incumbents will abandon the retail market, the FCC has misconstrued the very clear language in the Act. The Act specifically refers to "costs that will be avoided," not costs that may theoretically be "reasonably avoidable." The FCC seems to imply that if incumbent LECs are allowed to use real "avoided" costs, they will not properly reduce expenditures. This conclusion is totally unwarranted -- and the FCC's interpretation is contrary to the Act. U S WEST urges the Commission to follow the clear language contained in the Act, and to set wholesale discounts based on the actual costs avoided.

Q. DO THE PRICING PROPOSALS PRESENTED BY U S WEST IN THIS PROCEEDING COMPLY WITH THE FCC PRICING RULES?

A. U S WEST's cost studies generally comply with the TELRIC approach outlined by the FCC. In the following sections, I will describe how U S WEST's proposals conform to the FCC rules, and note a couple of small deviations from the FCC approach.

C. U S WEST'S PRICING FOR (INTERCONNECTION) SERVICES

1. TELRIC vs. TSLRIC

Q. HOW HAS U S WEST ESTABLISHED ITS RECOMMENDED PRICES FOR INTERCONNECTION, UNBUNDLED NETWORK ELEMENTS, TERMINATION AND TRANSPORT?

A. Consistent with the Act and the FCC's pricing rules, U S WEST's proposed prices for interconnection, unbundled network elements, termination and transport, are based on TELRIC studies that U S WEST has performed. These studies are presented and described in the testimony of Geri Santos-Rach. Per the FCC's rules, the U S WEST TELRIC studies include all of the forward looking direct costs of the element, plus the incremental cost of shared facilities and operations.[9] Per the FCC's rules,[10] costs are attributed to the TELRIC for specific elements to the greatest extent possible. Also, per the FCC rules, the U S WEST studies allocate a share of common costs to the elements.[11]

The prices for interconnection, unbundled network elements, termination and transport, are set at a level that is equal to the TELRIC for the element, plus an allocation of forward-looking common costs.

Q. WHY IS IT CRITICAL THAT PRICES BE SET BASED ON TELRIC STUDIES, AS DEFINED BY THE FCC?

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9 First Interconnection Order, Para. 682.

10 First Interconnection Order, Para. 682.

11 First Interconnection Order, Para. 694.

A. Prices must allow U S WEST to recover its full economic costs, including forward-looking direct, shared and common costs. To do otherwise would prevent U S WEST from recovering its legitimate costs, and would cause unwarranted financial harm to U S WEST -- for the benefit of its competitors. Prices that are not set to recover full economic costs may be considered confiscatory, as U S WEST discussed in its response to the FCC NPRM in docket 96-98.[12]

If prices do not cover their full economic costs, neither incumbent LECs, existing competitors or potential new entrants will have any incentive to invest in network facilities. In addition, if "interconnection" prices do not cover full economic cost, retail consumers will be faced with the prospect of either covering the shortfall left by new entrants' use of the network at below cost prices, or accepting the deterioration of the public switched network. Under either of these alternatives, Arizona customers would be harmed by competitive entry. I don't believe that is anyone's intent.

Q. DOES U S WEST INCUR FORWARD-LOOKING SHARED AND COMMON COSTS?

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12 For a detailed discussion of this issue, please see U S WEST's response to the FCC NPRM in Docket 96-98, submitted May 16, 1996, pages 23-38.

A. Yes. U S WEST does incur significant forward-looking shared and common costs. As the FCC recognized, shared and common costs are legitimate forward-looking costs that must be recovered if U S WEST is to remain in business.

In an efficient telecommunications network, a large portion of the network infrastructure is comprised of investment that is shared by many services or network elements. For example, a significant portion of transport and switching investment is not directly attributable to one service or network element, but is shared by many services and network elements. These costs are shared costs that are not included in the TSLRIC for a specific service or network element. Nonetheless, these are legitimate forward-looking costs that U S WEST incurs.

In addition, U S WEST incurs some costs that are common across all services, such as general accounting expenses. These are also legitimate costs of doing business on a forward-looking basis.

If service prices were set at TSLRIC, U S WEST would be unable to recover these legitimately incurred shared and common costs. It is for this reason that the FCC's pricing rules specify that shared and common costs must be included in a TELRIC study.

2. "Reasonable Profit"

Q. DOES THE ACT ALLOW U S WEST TO SET PRICES THAT INCLUDE A REASONABLE PROFIT?

A. Yes. As noted earlier, the Act allows U S WEST to set prices for interconnection and unbundled network elements that "includes a reasonable profit."[13]

Q. IF PRICES ARE SET AT A LEVEL EQUAL TO TELRIC PLUS A REASONABLE SHARE OF COMMON COSTS, DO THESE PRICES INCLUDE A REASONABLE PROFIT?

A. Profit is generally calculated on an historical "book" basis. Since TELRIC studies are forward-looking, pricing based on TELRIC may or may not include actual profit. However, U S WEST understands that the FCC has established a pricing methodology based on forward-looking costs, that should include a forward-looking "profit." Given this, it is essential that the TELRIC studies include the proper measure of forward-looking profit.

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13 Telecommunications Act of 1996, Section 252(d)(1)(B).

Q. HOW CAN THIS BE ASSURED?

A. TELRIC studies must consider the proper forward-looking economic depreciation lives and the proper forward-looking risk-adjusted cost of capital. The FCC agrees with this assessment:

> We conclude that an appropriate calculation of TELRIC will include a depreciation rate that reflects the true changes in economic value of an asset and a cost of capital that appropriately reflects the risks incurred by an investor.[14]

The studies that U S WEST is presenting in this proceeding are consistent with these requirements. Ms. Santos-Rach and Dr. Harris both discuss depreciation and costs of capital in more detail.

3. Geographic Deaveraging

Q. DO THE FCC RULES REQUIRE INCUMBENT LECS TO DEAVERAGE PRICES FOR INTERCONNECTION AND UNBUNDLED ELEMENTS ON A GEOGRAPHICAL BASIS?

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14 First Interconnection Order, Para. 682.

A. Yes. The FCC has determined that rates for interconnection and unbundled network elements must be geographically deaveraged[15] into a minimum of three zones.[16]

Q. HOW SHOULD THE COMMISSION ADDRESS THIS REQUIREMENT?

A. U S WEST believes that it may be appropriate to deaverage interconnection and unbundled network element prices on a geographical basis. However, the Commission must address this requirement within the context of U S WEST's entire rate structure. The Commission should refrain from deaveraging U S WEST's interconnection and network element prices until it has had an opportunity to deaverage the prices of U S WEST's retail offerings.

Retail and wholesale prices must be deaveraged at the same time, on the same basis. For example, the Commission should not allow the prices for unbundled loops to be geographically deaveraged, while maintaining average prices for residence and business basic exchange service. To do so would wreak havoc on the rate structure.

To illustrate, assume that the monthly price of a deaveraged loop in a high density urban area is $10 per loop, and that the monthly price of a deaveraged loop in a low density rural setting is $40 per loop. Also assume that the average retail rate for

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15 First Interconnection Order at, Para. 764.

16 First Interconnection Order at, Para. 765.

business basic exchange service (1FB) is $32 per month. Given this scenario, in high density urban areas, a CLEC will purchase $10 unbundled loops in combination with other elements to make a finished service, which would cost less than paying the 1FB wholesale rate ($32 less the avoided costs). However, in rural areas, a CLEC will not purchase unbundled loops at the high price of $40; instead, the CLEC will purchase average-rated 1FB service on a wholesale basis, since it can be purchased at a lower rate ($32 less the avoided costs).

The net result of this would be the loss of support from low-cost geographic areas to high cost geographic areas -- with no way to make it up. This situation, where wholesale rates are deaveraged and retail rates are averaged, simply allows the contribution which now flows from urban customers to rural customers to flow to the new entrants.

Q. HAS U S WEST CALCULATED THE TELRIC FOR UNBUNDLED LOOPS AND UNBUNDLED SWITCHING ON A DEAVERAGED BASIS?

A. Yes. The TELRIC studies presented in the testimony of Geri Santos-Rach provide local switching and unbundled loop costs on both a geographically deaveraged and averaged basis. The deaveraged TELRIC data is provided in order to comply with the FCC's deaveraging mandate. However, as noted above, U S WEST recommends that the prices for these network elements be deaveraged only when retail rates are deaveraged. Therefore, until retail rates are deaveraged, the Commission should set the same prices for each of the three cost area groups.

4. Recovery of Implementation Costs

Q. WILL U S WEST INCUR SIGNIFICANT COSTS TO IMPLEMENT THE INTERCONNECTION, UNBUNDLING, RESALE AND NUMBER PORTABILITY PROVISIONS OF THE ACT, THE FCC'S ORDERS AND THIS STATE'S RULES AND REGULATIONS?

A. Yes. U S WEST will incur substantial costs in implementing the requirements of the Act, the FCC's First Interconnection Order, and this state's rules and regulations. U S WEST will incur significant costs to ready its network and systems to provide not only interconnection, number portability and access to unbundled elements, including unbundled loops and operational support systems, but other things as well. While some of these implementation costs may be recovered through the rates U S WEST charges for interconnection, unbundled network elements, etc., these rates will not cover most of the cost of implementing these mandates. However, rather than addressing the complete recovery of these costs in this arbitration proceeding, U S WEST plans to request a separate proceeding to address this issue.

5. U S WEST's Pricing Recommendation

Q. WHAT ARE U S WEST'S SPECIFIC PRICING PROPOSALS FOR INTERCONNECTION, UNBUNDLED NETWORK ELEMENTS, TRANSPORT AND TERMINATION?

A. Exhibits A through I contain detailed information on all of the prices U S WEST is proposing in this proceeding. A detailed description of each product and rate element was contained in the initial arbitration proceeding for individual companies[17]. In the interest of reducing the redundancy and volume of paper, I have not included the detailed descriptions here.

D. U S WEST'S PRICING APPROACH FOR RESALE

1. Avoided vs. Avoidable Costs

Q. HOW SHOULD THE WHOLESALE DISCOUNT BE CALCULATED?

A. As noted above, the Act requires the wholesale discount to be calculated by identifying the "costs that will be avoided" by the local exchange carrier. Only those costs that are actually, not potentially, avoided through the wholesale

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17 See Docket Numbers U-3021-96-448, U-3245-96-448, U-2428-96-417, U-2752-96-362, U-3016-96-402, U-3175-96-479, U-3009-96-478, E-1051-96-478

provision of services should be subtracted. Thus, costs that are "theoretically avoidable" are not relevant.

Q. IN GENERAL, HOW SHOULD THE ACTUAL AVOIDED COSTS BE CALCULATED?

A. Per the Act, avoided costs include "marketing, billing, collection, and other costs that will be avoided by the local exchange carrier" by providing the service on a wholesale, rather than retail, basis. This means, for example, that the avoided cost considers the difference in marketing costs that would be incurred if the service were provided to a reseller rather than a retail end user customer. The avoided cost must be calculated on a "net" basis. That is, the marketing costs avoided by not serving retail customers and the additional marketing costs of serving resellers must be considered.

The FCC agrees with the "net" approach, concluding that " 'the portion [of the retail rate] . . . attributable to costs that will be avoided' includes all of the costs that the LEC incurs in maintaining a retail, as opposed to a wholesale, business."[18] In addition, the FCC notes that "some new expenses may be incurred in addressing the needs of resellers as customers."[19] and that in calculating avoided costs, these costs should be considered.

18 First Interconnection Order at, Para. 911.

19 First Interconnection Order at, Para. 928.

2. The U S WEST Avoided Cost Calculation

Q. PLEASE SUMMARIZE HOW U S WEST HAS CALCULATED THE AVOIDED COST DISCOUNT.

A. The U S WEST Avoided Cost study is included in the testimony of Geri Santos-Rach. In summary, U S WEST has calculated the costs that would be avoided when U S WEST provides services to resellers instead of retail end user customers. The study looks at each expense "account" and determines whether all, or a part, of the account will be avoided. Some accounts, like advertising and sales expense, are considered to be entirely retail expenses and are considered entirely "avoided." Other expenses, such as the customer services account, are considered to be partially avoided, since U S WEST will still need to process orders and provide some customer service to resellers. The precise methodology for this study, on an account by account basis, is provided in the study documentation attached to Ms. Santos-Rach's testimony.

The study calculates the actual avoided cost for several service groupings. The avoided cost is then restated as a percentage of revenues, which is applied to the retail rate to derive the wholesale price. For example, if the avoided cost represents 5% of revenues, the wholesale rate would be 95% of the retail rate. The discounts calculated in the avoided cost study are displayed in Exhibit J.

Q. IS U S WEST'S METHODOLOGY CONSISTENT WITH THE ACT'S REQUIREMENTS?

A. Yes. The study identifies the "costs that will be avoided," per section 252(d)(3) of the Act.

Q. IN THE FIRST INTERCONNECTION ORDER, DID THE FCC PROPOSE A METHODOLOGY FOR DEVELOPING AVOIDED COST DISCOUNTS?

A. Yes. The FCC indicated that there are two methods available for states to determine the avoided cost discount. The first, and preferred, method requires state commissions to identify and calculate avoided costs based on avoided cost studies. The second method would allow states to select, on an interim basis, a discount rate from within a default range of discount rates adopted by the FCC.[20]

Q. REGARDING THE FIRST METHOD (I.E., THE CALCULATION OF THE AVOIDED COSTS), DID THE FCC PRESCRIBE RULES THAT SHOULD BE FOLLOWED?

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20 First Interconnection Order, Para. 908.

A. Yes. The FCC established several criteria for an avoided cost study.[21] For example, the FCC requires the avoided costs to include both direct and indirect (i.e., shared and common) costs. In addition, embedded or incremental calculations may be appropriate. As noted earlier, the FCC prescribes a "net" avoided cost approach.

Q. IS THE U S WEST AVOIDED COST STUDY IN CONCERT WITH THE CRITERIA ESTABLISHED BY THE FCC?

A. Yes, except where, as noted earlier, the FCC's rules are not in compliance with the clear language of the Act. As noted earlier, the FCC advocates the calculation of costs that are "reasonably avoidable" whereas the clear language in the Act requires identification of the costs "actually avoided." The U S WEST cost study identifies costs that will be avoided, not theoretical costs that could be avoided if U S WEST were not in the retail business at all.

V. POLICY AND PUBLIC INTEREST CONSIDERATIONS

Q. WHAT POLICY AND PUBLIC INTEREST CONCERNS SHOULD THE COMMISSION CONSIDER IN THIS PROCEEDING?

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21 First Interconnection Order, Para. 908 to 931.

A. It is critical that the Commission understand the implications of the decisions it will make in this proceeding. What the Commission decides will ultimately determine whether there is a robust competitive environment, consisting of many alternative networks and providers, where the market determines who succeeds and who fails -- or whether there is a quasi regulated system consisting of a single monopoly provider and a few companies whose financial success is determined only by their ability to arbitrage the underlying carrier's rates and not through anything new or creative that is brought to the marketplace.

Q. **DO OTHER COMPANY WITNESSES ADDRESS SOME OF THESE CONCERNS?**

A. Yes. In his direct testimony, Dr. Robert Harris discusses the competitive environment which U S WEST will be facing and explains the importance of following sound economic principles in setting the rates for interconnection services. He certifies that U S WEST's cost studies are both economically sound and fully compliant with the FCC's TELRIC methodology. He also states that "unless the prices of network elements and the wholesale prices of resale services cover their respective economic costs, entrants will make biased choices, buying existing facilities rather than building new ones." Therefore, the prices established in this proceeding will impact not only U S WEST's ability to recover its costs, but will also decide the degree of competitiveness in the market for telecommunications services in Arizona.

In his direct testimony, Jerrold Thompson explains the potential implications of pricing on the Company's revenues and the resulting impact on its ability to generate the funds necessary to continue investing in Arizona. Mr. Thompson explains how adoption of the FCC's wholesale proxy rates for unbundled elements could reduce the amount of cash-flow available to finance additional construction in Arizona from $222 million to a mere $48 million. During 1995 U S WEST invested nearly $1 million a day ($347 million) in Arizona. It will be impossible to sustain that level of investment with only $48 million dollars of cash flow.

In order to understand how easily this could occur, consider the following: If the Commission were to allow U S WEST's competitors to engage in "sham unbundling", then all it would take for the scenario described by Mr. Thompson to occur would be for a company to petition and receive a certificate from the Commission to resale U S WEST's local exchange services. Then, without any more investment than it would take to either self provision or contract for billing services, the company could simply take out an ad in the newspaper and offer potential customers a discount off of U S WEST's price for the exact same services by doing nothing more than switching carriers -- something which could be done with a simple phone call or by sending in a coupon. Nothing else would change from the customer's perspective. They would receive the same service from the same provider -- but instead of paying U S WEST for their service, they would pay the reseller. In this situation, the reseller adds very little of any value to the marketplace. No investment is made in network facilities or switching equipment, no marketing force is employed to develop and sell innovative services, no repair technicians are hired to service a customer's account. The reseller exists only because of an arbitrage opportunity created through "sham unbundling".

Q. WHAT FINANCIAL INCENTIVES EXIST FOR COMPETITORS TO ENGAGE IN "SHAM UNBUNDLING"?

A. Today, U S WEST receives $60 per month in revenue from an average business customer. With "sham unbundling", if the Commission were to approve the FCC proxy prices, a reseller could provide the exact same service for around $20.00 per month by purchasing an unbundled loop for $12.85 per month and unbundled switching, which includes vertical features, for about $5.00 per month. That leaves a margin of nearly $40.00 between the competitor's cost to resell U S WEST's service and the revenues U S WEST is receiving today. It is not difficult to grasp how simple it will be to compete with U S WEST under these circumstances.

Let me be clear. It is important to note that this is not about the loss of retail revenue resulting from customers choosing a better product in the market. This is about U S WEST losing contribution from a customer who is still receiving the exact same service from U S WEST, but paying an intermediate company using arbitrage. Although there is a significant loss of revenue to the Company when this customer switches to a sham unbundler, there is not a corresponding reduction in costs. It is this same $40 that today provides contribution to help keep the rates for residence service low. After the Company loses the revenues that provide this contribution, there will be nothing left to which costs may be allocated and the retail price of residence lines will have to increase.

VI. CONCLUSION

Q. WHAT CONCLUSIONS SHOULD THE COMMISSION REACH IN THIS PROCEEDING?

A. First, the prices in this proceeding is critical to U S WEST, CLECs, and retail customers. The Commission must strike a balance so that all parties can benefit. Sham unbundling does not create that balance, but instead imposes severe competitive disadvantages and substantial financial losses on U S WEST. Hence, this Commission should exercise its jurisdictional authority to reject sham unbundling.

Second, the prices proposed by U S WEST in this proceeding are reasonable. They are based on TELRIC cost studies which have been shown to be fully compliant by the Company's witnesses and should therefore be adopted.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes.